



## AUTUMN 2012 LONDON RESIDENTIAL REVIEW

**Knight Frank**

### HIGHLIGHTS

- Prime central London house prices have risen 49% since March 2009 and are 14% higher than their previous market peak of March 2008.
- Miami is the only major global city to have outperformed London in terms of price growth over the past year.
- The main international buyers in London over the past three years were from Russia, India, Italy, the US and France.
- Prime central London rents hit a ceiling in October 2011 and have since declined, albeit marginally, by 2%.
- Over the past 12 months the rental market has seen 59% of all prime lets go to international tenants, with the largest share going to US, French and Italian ex-pats.

## UNREAL CITY

**London's prime residential market has defied the global economic downturn. Over the past three years every twist in the financial crisis has been greeted by yet another affirmation of the city's exceptionalism, Liam Bailey explains.**

"The prime London market has outperformed both the national market and its international peers."



**Liam Bailey**, Head of Residential Research

Since March 2009, when the tide began to turn after the global credit crunch, prices for prime London properties have risen 49%. In fact, prices have now risen to stand 14% above their pre-crisis peak back in March 2008.

Prices are not the only market metric to have surged. The nature of the market has shifted; in 2008 Knight Frank sold prime London properties to 36 nationalities while in 2011 the total hit 62.

This growing international aspect is not confined to the sales market. Over the past 12 months the rental market has seen 59% of all prime lets go to international tenants, with the largest share going to US, French and Italian ex-pats.

As we discuss elsewhere in this report, the prime London market has outperformed both the national market and its international peers. But it would be wrong to underestimate the challenges the market has faced.

In recent months the market has had to absorb a 40% rise in the top rate of stamp duty with new, and still undefined, rules for an annual charge on £2m+ properties held in certain ownership structures and the reform of non-resident capital gains tax rules.

In addition, the performance of London's economy has been weaker than hoped, with only a slow recovery from the 2008 recession. The diversification of the economy away from financial services has however gathered some traction.

More recently, while the Olympics were an undoubted success for London, they had the effect of keeping some prospective buyers away from the market during late July and August.

Despite these and other setbacks, the London market has thus far retained its spark. Prospective buyers and tenants have been fairly evenly matched with available properties in both sectors, although stock volumes have begun to creep upwards over the past six months.

"Over the past 12 months the rental market has seen 59% of all prime lets go to international tenants, with the largest share going to US, French and Italian ex-pats."

So, where to from here? Almost a year ago we set out our [forecast](#) for the prime market. Back then, we saw the potential for further growth in sales prices (5%), with limited although still positive growth in rents (1%).

We were right to be upbeat on the sales market. But with prices now 6% higher than at the start of the year, are we about to raise our forecast? In a word, no.

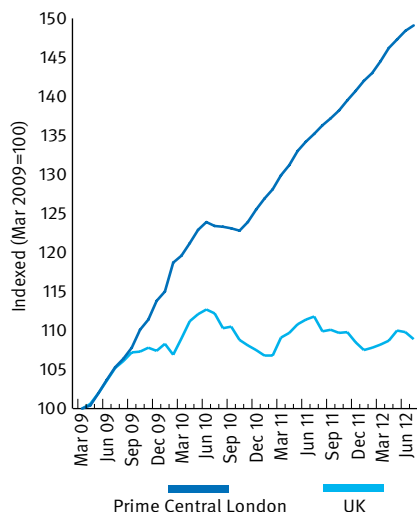
Our assumption is that prices are nearing their peak, at least for now. It seems highly unlikely that the new stamp duty rate will have anything other than a downward impact on pricing, especially in the £2m to £5m bracket, although we expect the prime central postcodes to be more robust.

Where we end the year depends on the appetite for London property from overseas buyers – a subject we explore in the next section.

For the rental market, the short-term outlook is mixed, but the medium-term outlook is becoming a little brighter, with London's job market and business investment in the capital beginning to look up.

Any conclusions on the outlook for the market need to be assessed in the context of the ongoing climate of political uncertainty. As we examine below, this year's stamp duty changes might not be the end for policy tinkering in the prime London market.

Figure 1  
**A sharp divide**  
Residential price change, indexed from March 2009



Source: Knight Frank Residential Research

## Wealth, globalisation and politics

### To understand London’s remarkable performance over recent years, we need to understand the global context.

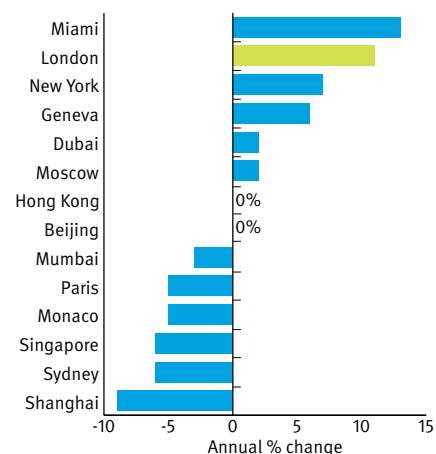
Any comparison between the prime London and UK housing markets only serves to confirm their almost total lack of connection.

The historic pattern saw each housing market cycle commence with price rises in London, followed closely by the South East of England, followed after two years or so by the rest of the UK. This pattern has been totally absent from the current cycle. London has boomed and the rest of the UK’s housing market has remained firmly on the floor (figure 1).

It is not just a national phenomenon. Take a look at how prices for prime property have performed round the globe in recent years and London stands out. Figure 2 confirms that over the 12 months to June this year, only one major global city had outpaced London in terms of price growth – Miami, which has been seeing its own boom on the back of South American, especially Brazilian, wealth flows.

Prices have performed well, but so too have sales volumes. Year-on-year sub-£2m prime sales volumes were higher by around 10% in Q1 2012, and 22% in Q2. The £2m to £5m bracket was very strong prior to the Budget,

Figure 2  
**Global city performance**  
Prime residential price change, 12 months to June 2012



Source: Knight Frank Residential Research

with sales up by 17% year-on-year in Q1. But in Q2 the market was hit by the new top rate of stamp duty, with a fall in like-for-like sales of 20%. Above £5m the market has been more robust, especially above £10m, where there was no decline in sales volumes compared with 2011 in Q2.

When we look at who is buying property, again we need to consider the global context. In figure 3 we confirm who the main buyers have been in London’s £1m+ market during the past three years. Note that for the £2m+ market, the UK market share falls from 59% to 47%.

London has long been a global market, but there can be little doubt that the market has become increasingly dominated by overseas buyers in recent years, the new-build sector doubly so. Why has this happened? Firstly, the influence of the City of London – the main driver for domestic demand – has shrunk. Where financial services once provided employment for 50% of prime London buyers, in the last 12 months this has been closer to 30%.

Domestic demand has therefore weakened, just as conditions began to favour money flows from other countries. One recent study by Fathom Consulting pointed to the performance of the pound as being the critical explanatory factor for London’s boom.

As we have noted before, the pound’s fall in 2008 was undoubtedly a catalyst for the market’s rise, but it fails to explain the continuance of the trend as the currency benefit has eroded.

The pound has strengthened against the Euro to the extent that the relative savings European buyers saw in early 2009 have now been eroded. Yet the share of the £2m+ market taken by European buyers, which doubled from 10% to 20% between 2008 and late 2010, remained at this elevated level through 2011 and into 2012.

‘Safe-haven’ investment flows are still playing out in favour of the London market, with the key driver, the Eurozone crisis, unlikely to become a neutral influence for some time.

There is a wider trend which has had an even larger impact on the London market. Global wealth creation, especially in Asia, but also in Russia, the Middle East and Africa, has created huge funds of money which need to be invested.

Figure 3  
**Who is buying?**  
£1m+ London sales by nationality, Q2 2009 to Q2 2012

Rank	Country	%
1	UK	58.9%
2	Russia	4.3%
3	India	3.6%
4	Italy	3.5%
5	US	3.3%
6	France	3.2%
7	UAE	1.8%
8	Australia	1.6%
9	China (inc Hong Kong)	2.4%
10	Greece	1.3%
11	South Africa	1.2%
12	Germany	1.0%
13	Singapore	0.9%
14	Ireland	0.8%
15	Saudi Arabia	0.6%
16	Lebanon	0.6%
17	Spain	0.6%
18	Egypt	0.6%
19	Switzerland	0.5%
20	Canada	0.5%

Source: Knight Frank Residential Research

## Global wealth flows and domestic politics

The impact of this new wealth creation is felt across the central London market, but one of the most obvious results has been the now well established path for prime London developers to travel to Asia to sell new-build flats in London’s most exclusive postcodes ‘off-plan’.

This sounds like a win-win. The government, hungry for economic activity, wants more construction. But for the past five years a developer in need of bank funding has sounded more like the title of a H.M. Bateman cartoon than a realistic proposition. And this is where the world’s new wealth has stepped in, buying a portion of flats in each development off-plan, something which is more difficult for the UK investor facing very restricted mortgage lending. This process effectively helps to ‘de-risk’ schemes; encouraging bankers to fund the remainder of the development.



What's not to like? For some people, quite a lot, it seems.

To explain, let's briefly turn to Asia. One of the biggest stories from Singapore, Taiwan, Malaysia, China and Hong Kong has been government policy action in response to domestic house price rises caused largely by the new wealth I mentioned previously.

Avid readers of our rather excellent [global residential reporting](#) will be familiar with the response from Asian governments and the barriers they have put in place to stop this money from entering the housing market. As a consequence, it is harder and more expensive to get a mortgage, the stamp duty you pay varies depending on your residency, capital gains taxes are rising, and the locations where non-residents can buy has narrowed.

In Singapore, one of the traditional markets for Asian cross-border investment, the result has been dramatic with the number of units sold to non-permanent residents (overseas buyers) falling 76% in Q1 2012 compared to Q4 2011. Figure 2 confirms the relative weakness of recent price growth in the key Asian centres, which in part results from recent policy activism.

**“Year-on-year sub-£2m prime sales volumes were higher by around 10% in Q1 2012, and 22% in Q2.”**

What has all this got to do with London? The UK has not been immune to policy shifts recently, with changes made to both stamp duty and capital gains taxes, largely targeted at foreign buyers. But these have been small beer compared to the dramatic shift away from the open market presumption in key Asian markets.

You might think that this year's UK Budget statement marked the high watermark for wealth and property tax changes. But since the Chancellor of the Exchequer made his speech there have been a number of calls from think tanks and academics for more action to limit foreign investment in London's housing market.

Two reports in particular stand out. The IPPR led the way in its May 2012 report [“Affordable Capital?”](#). The Smith Institute then tagged along in July with its report [“London for sale?”](#).

The general assertion in both reports is that foreign investment is creating a dysfunctional market in London; pricing is no longer related to normal rules of demand and supply but is a function of the interaction between global wealth flows and exchange rates, to the disadvantage of the local resident.

The Smith Institute spoils its case when it embellishes its central narrative to suggest that many foreign investors leave their properties empty, which seems to point to a misunderstanding of investment economics and motives. As we examine in our lettings market analysis below – the vast majority of investors focus on total returns – capital growth *and* rental income.

Setting this and other weaker elements aside, the central point from these reports, confirmed by figure 1, is that the international dimension of London's market has been the critical factor driving price growth, ensuring the differential in performance between it and the wider UK market.

For the think tanks, and others, this differential suggests that action needs to be taken. In simple terms this means creating barriers to entry to London's housing market to non-residents.

Will it happen? There are a fair few hurdles to negotiate. Asking the government to define good versus bad inward investment is going to be problematic; the construction industry can fairly claim that without foreign investment there will be far fewer new housing completions; and this approach would represent a huge shift away from the UK's presumption in favour of global economic and trade freedom, at a time when inward investment is desperately being encouraged by the government.

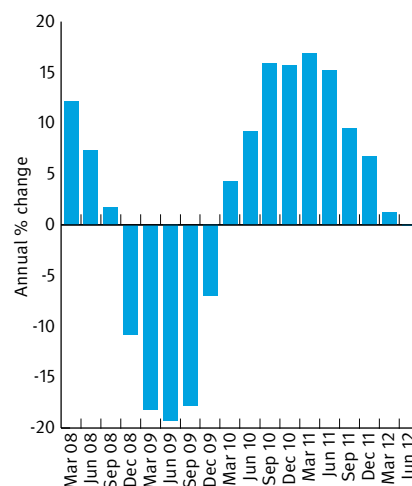
The problem, to my mind, is that it really doesn't matter too much what Singapore does to restrict foreign investment, the city-state is in the right part of the world, can afford the right tax rates, and will prosper even with the odd barrier to property ownership here and

there. But the UK? It would seem to be a fair claim that possibly the strongest economic card the UK holds is London's global entrepot status. Property market protectionism would not be a great step to take to enhance that role.

However, the loud reverberations from the financial crisis, along with the joys of coalition government, do not always lead to constructive policy making. Before discounting the chances of market protectionism, bear in mind that when the previous Conservative Chancellor of the Exchequer left office in 1997, the UK's top rate of stamp duty for house purchases by individuals was 1%. 13 years later, when New Labour lost power, it had risen to 4%. It has taken the new coalition government less than two years to raise it to 7%. Nothing seems impossible anymore.

**“A bounce in activity in 2010 and 2011 saw London's gross value added (GVA) measure of economic activity climb by an annual 1.9% and 1.7% respectively.”**

Figure 4  
**London rental growth fizzles...out**  
Annual growth in prime central London rents

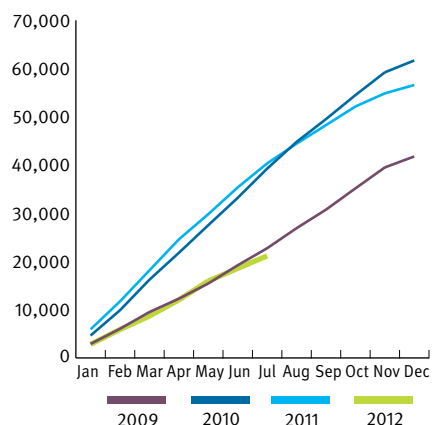


Source: Knight Frank Residential Research

## London's economy and the lettings market

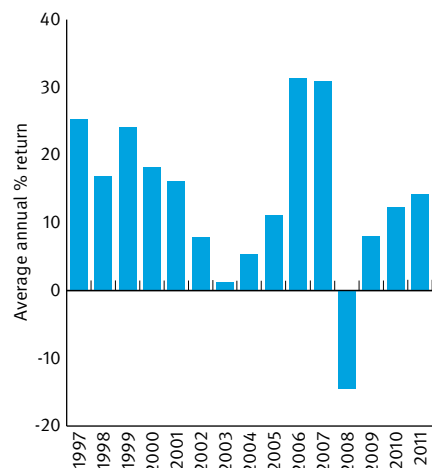
**While the prime London lettings market is as globalised as the sales market in terms of the composition of tenants and increasingly landlords, its fortunes are more closely tied to the performance of London's economy.**

Figure 5  
**Central London employment**  
Cumulative "new jobs" count



Source: Morgan McKinley

Figure 6  
**Total returns**  
Annual capital growth and average annual net income returns, prime central London



Source: Knight Frank Residential Research

Like sales prices, prime rents have recovered rapidly since the market downturn in 2008-09, and are now nearly 25% higher than they were in mid 2009. But unlike capital values, rents hit a ceiling in October 2011 and have since declined, albeit marginally, by 2% (figure 4).

The main factor dragging down rents has been the state of the London economy. A bounce in activity in 2010 and 2011 saw London's gross value added (GVA) measure of economic activity climb by an annual 1.9% and 1.7% respectively. But by the end of 2011 the economy was slowing as the Eurozone crisis put downward pressure on growth, confidence and recruitment, and the current estimate for London's full-year 2012 GVA growth stands a little below 1%.

This weakness can be seen in data from [Morgan McKinley](#), which confirmed that in terms of new employment vacancies in central London, 2012 is far underperforming the picture seen in both 2010 and 2011. The figures show that 2012 is in fact running a close race with 2009 to be the worst year for new vacancies since Morgan McKinley started recording this data in 2004 (figure 5).

We shouldn't therefore be too surprised that rents have moved down over the past nine months. While our 1% growth forecast for 2012 is still plausible, anything much stronger seems unlikely.

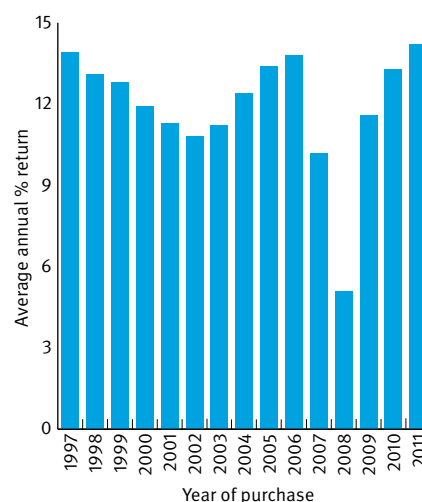
But while rents may be performing below trend, activity has risen, with new lettings volumes in the first half of 2012 22% higher than the same period in 2011. This increase in activity reflects a broader shift in favour of the rental sector across the UK, due to the lack of mortgage market funding for new entrants in the owner-occupier market. Activity was also boosted by tenants moving ahead of their tenancy expiring due to fear that their landlords would cease their tenancy to allow for short lets over the Olympic period.

For landlords this trend should permit above-inflation rental rises over the medium term, potentially helping to halt the long-term decline in income returns on prime residential investment.

While gross yields of 3.5% have become more common in central London, investors' attention is on total returns, the welcome confluence of capital growth and rental income. As figure 6 confirms, average annual total returns have stood at 11.4% over the last three years.

That last stat may not have impressed you; after all, strong growth following a seismic downturn is perhaps not all that surprising. However, you may find figure 7 a little more interesting. It might even give some comfort to investors concerned about the stability of current pricing in the prime market. In the chart we calculated the average annual total return an investor would have received on their prime London property since the date of purchase. It's not a bad image to end on.

Figure 7  
**Average total returns since purchase**  
Average total return calculated from 'year of purchase'



Source: Knight Frank Residential Research



# RESIDENTIAL RESEARCH

## Belgravia

**Sales** Stuart Bailey  
**Lettings** Tom Smith  
+44 (0)20 7881 7720

## Canary Wharf

**Sales** Andrew Grocock  
**Lettings** Vanessa Evett-Beesley  
+44 (0)20 7512 9955

## Chelsea

**Sales** James Pace  
**Lettings** David Mumby  
+44 (0)20 7349 4300

## City

**Lettings** Gary Hall  
+44 (0)20 7606 1560

## Fulham

**Sales** Anne Soutry  
**Lettings** Nicola Miller  
+44 (0)20 7751 2400

## Hampstead

**Sales** Grant Alexson  
**Lettings** Greg Bennett  
+44 (0)20 7431 8686

## Hyde Park

**Sales** Sarah Harding  
**Lettings** Erin Van Tuil  
+44 (0)20 7871 5060

## Islington

**Sales** Daniel Omell  
**Lettings** Lauren Rapacioli  
+44 (0)20 3657 7340

## Kensington

**Sales** Mark Redfern  
**Lettings** Giles Barrett  
+44 (0)20 7938 4311

## Knightsbridge

**Sales** Eliza Leigh  
**Lettings** Juliet Hill  
+44 (0)20 7591 8600

## London Riverside

**Sales** Matt Smith  
**Lettings** Mark Howell  
+44 (0)20 3597 7670

## Marylebone

**Sales** Christian Lock-Necrews  
**Lettings** Erin Van Tuil  
+44 (0)20 7483 8349

## Mayfair

**Sales** Harvey Cyzer  
**Lettings** Kate Townrow  
+44 (0)20 7499 1012

## Notting Hill

**Sales** Caroline Foord  
**Lettings** Sophie Woolfenden  
+44 (0)20 7229 0229

## Richmond

**Sales** Luke Ellwood  
+44 (0)20 8939 2800

## South Kensington

**Sales:** James Pace  
**Lettings:** David Mumby  
+44 (0)20 7871 4111

## St John's Wood

**Sales** James Simpson  
**Lettings** Louise O'Driscoll  
+44 (0)20 7586 2777

## Wandsworth

**Sales** Luke Pender-Cudlip  
**Lettings** Sarah Peck  
+44 (0)20 8682 7777

## Wapping

**Sales** Sarah Shelley  
**Lettings** Gary Hall  
+44 (0)20 7480 6848

## Wimbledon

**Sales** Dominic Pasqua  
**Lettings** Ruth Barr  
+44 (0)20 8946 0026

## Residential Research

**Liam Bailey**  
+44 (0)20 7861 5133  
liam.bailey@knightfrank.com

## Head of London Residential

**Noel Flint**  
+44 (0)20 7861 5020  
noel.flint@knightfrank.com

## Head of Lettings

**Tim Hyatt**  
+44 (0)20 7861 5044  
tim.hyatt@knightfrank.com

## Residential Valuations

**James Thompson**  
+44 (0)20 7629 8171  
james.thompson@knightfrank.com

## Residential Corporate Services

**Jemma Scott**  
+44 (0)20 7861 5244  
jemma.scott@knightfrank.com

## Head of Sales

**Eliza Leigh**  
+44 (0)20 7861 1778  
eliza.leigh@knightfrank.com

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[UK Prime Country House Index Q2 2012](#)



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**Knight Frank area definitions:** 'Prime central London' is defined in our Prime Central London Sales Index as covering: Belgravia, Chelsea, Hyde Park, Kensington, Knightsbridge, Marylebone, Mayfair, Notting Hill, Regent's Park, St John's Wood, Riverside\* the City and the City Fringe. 'Prime London' comprises all areas in prime central London, as well as Canary Wharf, Fulham, Hampstead, Richmond, Wandsworth, Wapping and Wimbledon.

\* Riverside covers the Thames riverfront from Battersea Bridge in the west running east to include London's South Bank. The City Fringe encompasses the half-mile fringe surrounding most of the City including Clerkenwell and Farringdon in the west and Shoreditch and Whitechapel in the east.

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